Buying or selling: Key factors for sales rep agency valuation

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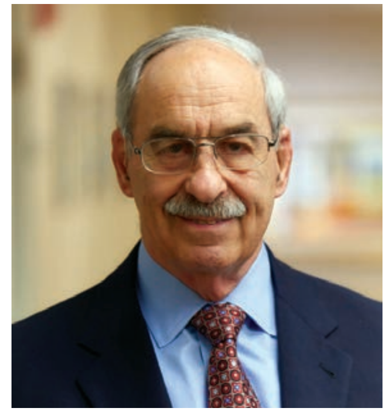

by Gerald M. Newman
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Leonard J. Gambino

Recently, a client requested our help with a succession plan. The rep agency had two 50 percent owners. One of the owners had a son active in the business and wanted to transfer his stock to his son. Both owners, as well as their accountant, had assumed that the stock was essentially worthless. Based on our analysis, however, including the application of a reasoned valuation formula, a purchase price was derived of approximately $600,000 for 50 percent of the stock.

A common starting point in valuing a rep firm is to look at 100 percent of the previous year's gross commission income. From there, it is important to consider several factors that tend to increase or decrease the value. Factors such as long-term and stable relationships with principals and customers, selling products with a promising future in the market, and the firm's commission income stream on the rise, tend to increase the price. Meanwhile, downward sales trends, short-term relationships, high employee turnover, and a concentration of revenue in a small number of customers or principals are factors that tend to lower the price of a rep firm.

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Sellers often desire the perceived certainty which comes with a fixed purchase price. A fixed purchase price is typically based on historical performance. Ordinarily, the price can be as simple as 100 percent of the previous year's gross commission income, or it can be based on an average or weighted average of two or three prior years. A fixed purchase price appears to favor the seller, unless commission income is expected to grow substantially in the near future. In reality, however, few sellers are motivated to sell at a time when commission income is steadily growing.

Buyers and sellers should both be concerned about a fixed purchase price when the loss of a key line or territory, or the loss of a key customer or key sales employee, can have a substantial negative impact on the value of the agency and its ability to pay the purchase price. This is so because the purchase and sale of a rep agency is almost always a "bootstrap transaction," i.e., the buyer's ability to pay the purchase price, and the seller's ability to get paid, is always dependent on the stream of income available from the business itself.

As a result, in transactions with a fixed purchase price, the parties often allow for the purchase price to be adjusted downward in some fashion upon the loss of a key line, territory, or customer. This protects the buyer, of course, and fairness would dictate that an upward adjustment should occur if business improves. Otherwise, the seller is asked to accept the downside risk while receiving no upside benefit.

If the parties mutually expect that business will only decline, this can prove acceptable, but this is seldom the case.

We tend to favor a variable purchase price based on future performance, whether we are representing the buyer or the seller. For example, the price could be 15 percent of gross commission income for the seven years following the sale, which equates to 105 percent of gross commission income. Moreover, we have found that most agencies can afford to pay 15 percent of gross commission income after a sale without threatening their all-important cash flow.

If the agency value increases due to positive business factors, the payment term might be extended. For example, payment of 15 percent of gross commission income for 10 years following the sale equates to 135 percent of gross commission income. This approach provides the buyer with downside protection, while also yielding an upside benefit to the seller.

Parties using a variable purchase price will

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LEGALLY SPEAKING: Valuing a sales rep agency

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sometimes include a cap and a floor on the price. This can assure the buyer will never "pay too much" and the seller will never "receive too little."

In addition to their commission income, some reps also act as distributors, buying inventory from the principal and selling it at the markup they can obtain in the market. Valuing this part of a rep business is different than the straight commission business.

Three components are potentially involved in valuing the buy-sell portion of the business: inventory, accounts receivable and gross margin. A buyer may or may not buy the inventory or the accounts receivable. If they do, saleable inventory is typically valued at the lower of cost or market, and accounts receivable are typically valued at their face amount, less an appropriate discount for doubtful accounts. If the buyer is acquiring the accounts receivable, the buyer should also assume the trade accounts payable.

The real issue, however, is valuing the buy-sell business as a going concern. Here, the parties typically use gross margin rather than gross commission and apply the same formulas discussed above.

In connection with succession planning, the goal is always to craft a valuation formula that not only results in an appropriate value, but one that can also be applied without generating controversy or incurring substantial expense. For these reasons, we generally avoid using a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization), or providing for the value to be determined by a third-party appraiser.

Clients are also counseled to avoid using a fixed value as of a certain date, subject to periodic review and adjustment. Experience teaches that most rep agencies will neglect to actually review and adjust. This can result in a dispute when a triggering event occurs and an outdated valuation is reflected on the books.

Bearing these general principles in mind, it remains the case that every rep agency is unique and, therefore, every agency valuation requires careful attention paid to both the factors identified above, and the particular goals of the buyer and seller. Reps considering buying or selling an agency are well-advised to keep these valuation approaches in mind. ■

FEATURE ARTICLE: How PEOs can help

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the best trajectory for growth. Having a team of HR experts proactively directing your path can keep your business from taking a wrong turn and losing momentum.

PEOs remove guesswork from planning by working with you to:

- Identify skill sets your company needs to reach growth objectives;
- Create detailed job descriptions and establish a strategic selection process;
- Design and implement an ongoing performance management process;
- Develop company policies and practices to help limit your liability and costly litigation;
- Receive guidance on how to establish competitive pay so you can attract and retain talent; and
- Develop your company's mission, vision and values.

Work with a PEO to help ensure everything is aligned and pointing in the same direction. You can fully examine your current organizational structure, departmental and individual goals, and company policies. Your growth will be a thoughtful and deliberate process that will continue to support your business through every cycle.

Meanwhile, a PEO can help keep your business on the right track by taking on much of the cumbersome jobs of HR administration so that you have more time and resources to devote to running your business.

When the burdensome responsibilities of employer-related governmental compliance, HR strategy and growth plans are handled proactively, you will have fewer HR concerns — opening the door for you to achieve success. ■